Q4 2010 Results Conference Call

February 24, 2011 at 15:00 CET

Jó napot kívánok! Good afternoon ladies and gentlemen and welcome to Magyar Telekom's fourth quarter 2010 results conference call. I am Thilo Kusch, Magyar Telekom's CFO and a member of the Board, and I will be hosting today's call.

2010 has been a controversial year. On one hand we saw some positive signs of recovery in the Hungarian economy, which are also reflected in our fourth quarter results. On the other hand, the new governmental measures including the telco tax and the ongoing renegotiation of public contracts affected last year's results and make us to be cautious about our future performance. Nevertheless, we have achieved our public targets for last year, with a revenue decline of 5.3% and an EBITDA decline, excluding not only special influences, but also the telecom tax, of 5.5%. Even better fourth quarter numbers with a 3.9% revenue decline and a 1.6% increase in the EBITDA are proof that market trends are improving. As before, these figures exclude special influences and the telco tax.

Admittedly, the overachievement of the public targets is compared to the lower targets announced in August last year. Our guidance of 6-8% revenue decline and 7-9% EBITDA decline reflected our expectations of a higher impact of the governmental austerity measures. While we still foresee the same total impact from these measures, i.e. about 5 to 7 bn forint revenue and EBITDA impact, the effect on last year's results was limited to around 1 bn forint revenue and 1.3 bn forint EBITDA, however, the cash flow was fully hit. This also means that our results in the coming years will be affected to the tune of the remaining 4-6 billion forint.

We took this into account when setting our public targets for this year of a 3-5% revenue decline and a 4-6% underlying EBITDA decline, also excluding the telecom tax. In terms of CAPEX, we made a significant, 10% cut last year. As a result, we have limited room for further cuts and for this year, we are planning to reduce our CAPEX by around 5%.

Now let's return to last year's performance and take a closer look at the fourth quarter results. As mentioned before, fourth quarter revenues declined by 3.9%, while in the first three quarters revenues were down by 5.8%. The positive trends can mostly be observed in the broadband internet and IPTV markets in the fixed line market, and in the customer numbers and usage on the mobile side. On an underlying EBITDA level, also excluding the telco tax, we posted a 1.6% increase compared to the fourth quarter of 2009. This was achieved through substantial cost cutting, especially in the employee-related costs and other operating expenses.

Before turning to the segment results, let me also mention the strong cash flow generation in 2010. The free cash flow, measured as the sum of operating cash flow and investing cash flow adjusted for proceeds from and payments for other financial assets, was down by 5 bn forint despite the 27.5 bn forint telco tax advance payment. The cash flow was helped by lower interest payments, thanks to the lower interest rates, by the cut in CAPEX and by the significant decrease in adjustments to cash purchases. I think this latter item deserves some more explanation. Adjustments to cash purchases, also known as CAPEX creditors, improved last year's cash flow by 4 bn forint while decreased it by 8bn forint in 2009. This can be fully explained by the difference in the December CAPEX spending volumes. Usually, we spend a quarter of the annual CAPEX budget in December, but the spending in 2009 was distributed more evenly across the year. This resulted in lower CAPEX payables at the end of 2009 compared to the end of 2008 and 2010, causing a negative cash flow item in 2009 and a positive one in 2010. We are also extending payment terms with our suppliers, as one of the measures taken to combat recessionary effects, which also increased payables in 2010. Going forward we don't expect year end CAPEX spending to fluctuate as much and the impact on cash flow should also be lower.

I will now turn to the analysis of the business units, starting with our Consumer Business Unit. Revenues in the fourth quarter were down by 1% overall due to the continuous decline in our fixed line voice revenues which was mostly offset by increasing TV and mobile internet revenues. Thanks to the significant cost reductions we have implemented, particularly in lower employee-related expenses, EBITDA increased by 1%.

In the fixed line market we continued to execute our strategy aimed at positioning Magyar Telekom as a leading multi-play operator with a focus on TV services. As a result of this strategy, the number of our customers who subscribe to bundled fixed line services continued to increase. The percentage of double and triple play residential subscribers increased from 35% to 43% by the end of this quarter compared to the same period in 2009. In addition, we see great demand for our quadruple-play offer launched in the autumn, where mobile voice is bundled with fixed line services. We gained 30,000 quadruple-play customers by the end of last year. The multi-play packages also made voice services more compelling, and the different IP based voice solutions are generating increasing subscriber numbers. As a result, we stabilized the trend in falling fixed voice revenues and saw a steady decline in fixed voice churn. To support this trend and increase retention, we launched a new flat fixed voice package at the beginning of this year. For a fixed monthly tariff, all Hungarian fixed line and T-Mobile numbers can now be called for free.

In the broadband internet market, the continuously falling ARPU as a result of customers migrating to lower priced packages was offset by the growing subscriber base on DSL, cable and fiber platforms resulting in a 1% internet revenue increase in the residential segment. Although fiber penetration remains at only 11% overall, we see a number of signs that give us grounds for optimism: almost half of the fiber subscribers are new to Magyar Telekom and a quarter of them migrated from a single-play package, which is the segment most susceptible to churn. The average service per subscriber reached 2.5 on the fiber network, which compares favorably to our overall average of 1.6 service per subscriber at the end of 2010.

Moving on to the TV market, our subscriber base grew by 19% which resulted in a 9% increase in TV revenue in the fourth quarter of 2010 compared to the same quarter in 2009. Not only did the satellite TV subscriber numbers show dynamic growth, but since the introduction of the cable platform based IPTV, the number of IPTV subscribers is also increasing rapidly. While the share of TV revenues is only a fifth of total residential fixed revenues, the retention impact of this service is the highest. For a single play customer, the average churn is 19%, for a double play it only 13%. The percentage drops to 9% for triple play customers.

Moving on to the residential mobile market, total mobile revenues increased by 2% in the fourth quarter of last year compared to the same period in 2009. This was mainly driven by the increasing number of mobile broadband subscribers, growing mobile usage and improving customer composition. These successfully offset the effect of the declining effective tariff levels driven by the competition and cut backs in consumer spending. Two 16% cuts in mobile termination rates effective from January 2010 and from December 2010 had a negative effect on mobile wholesale revenues. I would like to highlight that both the total number of active voice customers and our market share among them increased by the end of 2010 compared to the end of 2009.

Meanwhile, the mobile internet market continued to expand dynamically and we witnessed a strong increase in both our subscriber base and revenues. T-Mobile managed to maintain its clear market leading position in mobile broadband with 49% market share among traffic generating subscribers. Going forward, smart phone prices are expected to fall below 100 euros and we anticipate these handsets to be the main driver of growth in the mobile data in own markets. With smart phone penetration at just around 5%, we see significant upside for Hungary in this respect. At the same time, sales figures are improving; around a third of the handsets sold by Magyar Telekom in the fourth quarter of 2010 were smart phones generating high margin data revenues, while this ratio stood at around 20% in Q3.

Now we turn our attention to the **Business Services Business Unit**, which endured a difficult year in 2010. The macroeconomic environment in Hungary remained difficult, and although some indicators started to improve by the end of the year, telecommunication spending remained at low levels. Our private sector customers continued to be very cost conscious while our public sector clients had to pass on the budget deficit cuts. The combined effect of these two trends resulted in a 10% revenue decline in the fourth quarter of 2010 compared to same period of the previous year. The strongest drop was in SI/IT revenues, where there was also a base effect due to the extremely strong fourth quarter in 2009.

The churn of our fixed line customers remained relatively high, as a result of fierce competition supported by the IP based fixed voice solutions and ongoing mobile substitution. Mobile voice revenues were under pressure due to continuous price renegotiations, which could not be offset by a higher number of customers and a slight increase in usage.

Other mobile revenues were negatively affected by the renegotiation of governmental contracts, but the effect was not as bad as we previously anticipated. Mobile broadband revenues increased, partly because of increased sales in smart phones.

The 15% decline in system integration and IT revenues was due to very strict budgetary measures, as governmental institutions stopped IT investments by the year-end. This could not be offset by the consolidation of ISH, our healthcare IT service provider subsidiary acquired in December 2009.

EBITDA margin was slightly down to 41%.

Moving to our **Macedonian** subsidiary, total revenues decreased by 1% in the fourth quarter of 2010 compared to the same period in 2009, whilst EBITDA increased by 20%. EBITDA margin improved significantly from 40% in the corresponding period of the previous year to 48% in the fourth quarter of 2010. This reflected a lower cost of equipment, cost saving measures, especially in marketing, and lower provisions in the fourth quarter of last year.

In the <u>fixed line segment,</u> revenues were up by 6% in the fourth quarter of 2010 as growth in wholesale voice, internet, data and TV revenues more than offset the 20% drop in retail voice revenues. Despite the competition in the retail voice market, the fixed voice churn declined to 8% by the end of 2010 compared to 13% a year before. The higher voice wholesale revenues were due to the combined impact of growing incoming traffic volumes and higher prices charged for international traffic termination. At the same time, the focus on double and triple play packages gave further impetus to rising internet and TV revenues.

<u>Mobile revenues</u> declined by 6% in the fourth quarter, primarily due to lower retail voice revenues which could not be counterbalanced by the increasing wholesale revenues. The main reason for falling retail voice revenues is the intensifying competition, which is putting sustained pressure on tariff levels. The increasing post-paid ratio and the higher usage could not offset the 11% decline in the average tariff level. While T-Mobile Macedonia's market share decreased to 51% from 56% a year ago, the company continued to maintain its clear market leader position. At the same time, demand for mobile broadband services is increasing, also supported by iPhone sales, and T-Mobile Macedonia continues to expand its 3G coverage.

Regarding our **Montenegrin** subsidiary, total revenues increased by 1% in forint terms, while EBITDA decreased by 19% in the fourth quarter compared to the same period of 2009. The significant drop in EBITDA is mainly due to one-off items and was not driven by changes in market trends. So the underlying EBITDA was almost flat.

Fixed line revenues were broadly flat as declining voice revenues were offset by higher broadband and IPTV revenues. Fixed line voice revenues remain under pressure as a result of heavy mobile substitution whilst wholesale voice revenues were affected by the significant fallout of international traffic towards Serbia. A considerable part of that traffic is now transited by our competitors. We are focusing on product bundling in Montenegro as well, which resulted in 40,000 IPTV and 69,000 broadband internet subscribers representing annual growth of 35% and 25%, respectively. We managed to maintain our 86% market share of the broadband market and significantly increased our market share of the pay TV market from 27% to 37%, strengthening our market leading position even further.

Mobile revenues were also broadly flat in the fourth quarter of 2010 compared to the same period of 2009. Voice revenues were slightly down, as both the customer base and ARPU declined. In addition, visitor revenues were lower despite the stable level of visitor minutes due to the higher discounts offered. These were mostly offset by higher equipment sales revenues. Finally, since the last quarter of 2010 we have been the first and only Blackberry service provider and iPhone 4 distributor in Montenegro.

That concludes the formal part of Magyar Telekom's conference call. I am now happy to open the floor for questions. Operator, when you are ready, we will take the first question.

(Take questions)

I believe we have time for one more question.

(Take final question)

If there are follow-up questions, I encourage you to contact our Investor Relations Department. The telephone number is 36-1-458-0424 or, if you would like to send an e-mail you can address it to investor.relations@telekom.hu. I would like to inform you that the transcript of our conference call will be available on our official website. Thank you again for joining us today, and for your continued interest in Magyar Telekom.